Competition and the Financial Impact of the Proposed Tobacco Industry Settlement

This report has been prepared by staff members of the Bureaus of Economics, Competition, and Consumer Protection. The views expressed do not necessarily reflect those of the Commission or any individual Commissioner.

The information contained in this report is taken from public sources. References to trial exhibits reflect information made public in the FTC v. B.A.T Industries p.l.c. 94 Civ 7849 (filed October 31, 1994, S.D.N.Y.)

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Executive Summary

This report has been prepared by staff of the Federal Trade Commission in response to the August 1, 1997 request from Representatives Martin T. Meehan, Henry Waxman, and James Hansen on behalf of the members of the Congressional Task Force on Tobacco and Health for an analysis of the potential economic impact of the proposed settlement with the tobacco industry on cigarette prices, industry profits, and government revenues. The report represents the work of the Bureaus of Economics, Competition, and Consumer Protection. As a staff report, it does not necessarily reflect the views of the Commission or any individual Commissioner.

Expertise of the Commission

The staff of the Commission has extensive experience, collected over decades, examining the competitive structure of the tobacco industry as well as its advertising and marketing practices. Pursuant to the Federal Cigarette Labeling and Advertising Act, 15 U.S.C. § 1331, the Commission annually reports to Congress on sales volume and advertising expenditures by the major domestic cigarette manufacturers. The Commission has additional responsibilities under the Cigarette Labeling and Advertising Act, and has investigated and periodically challenged cigarette advertising under Section 5 of the FTC Act, 15 U.S.C. § 45, which prohibits unfair or deceptive acts or practices. In addition, the Commission has investigated competitive practices of the cigarette firms and challenged the 1994 merger between the American Tobacco Company and Brown & Williamson.

Summary

One primary goal of the settlement is to reduce overall use of tobacco products, and in particular to reduce youth smoking. That goal is intended to be achieved by advertising and marketing restrictions, by raising the price of cigarettes and by a provision imposing financial penalties on cigarette manufacturers if certain goals for youth smoking reduction are not met. The price increase is realized by requiring manufacturers to make annual industry payments that will, among other things, fund various federal and state programs relating to tobacco usage. The proposed settlement contemplates that these industry payments will be "passed through" to consumers, which will result in higher cigarette prices, and presumably in turn, a reduction in youth smoking.

From an antitrust and economic perspective, a proposal that Congress enact a statute enabling private firms to agree to raise prices to pay past liabilities should be viewed with caution. This report does not directly address the policy choice between traditional antitrust and economic concerns and other important public policy and public health concerns. Rather, it is limited to the question posed by the Task Force -- the potential *economic* impact of the settlement on the industry and the public sector. Cigarette prices will rise if the settlement is enacted. This report addresses how much prices will rise and who will benefit from the anticipated increased revenues that flow from the price increases.

One critical aspect of the proposed settlement is a provision that confers on the tobacco companies a broad degree of immunity from the antitrust laws. A narrowly focused exemption, permitting the firms to collaborate with respect to certain conduct that would curtail advertising to underage smokers, might be appropriate to advance the stated goals of the settlement. But as currently drafted, the antitrust exemption would permit these firms to "jointly confer, coordinate, or act in concert" to achieve all the goals of the settlement. Such sweeping antitrust immunity appears to be unnecessary for implementation of the settlement. Moreover, broadly drafted immunity might permit a variety of activities that would enable the firms to raise prices of cigarettes beyond the level needed to satisfy industry payments under the settlement.

The important conclusions of the report are:

- The major cigarette manufacturers may profit from the proposed settlement by increasing the price of cigarettes substantially above the amount of the annual payments that are to be paid to the public sector. Based on the history of the industry and its current structure, the companies likely would raise prices by at least the per-pack payments they would be required to pay to the public sector under the settlement, even in the absence of an explicit requirement to "pass through" the cost of the payments. Moreover, certain features of the proposed settlement, particularly the antitrust exemption, have the potential to reduce competition and enhance the ability of the cigarette companies to "coordinate" price increases. If so, the industry may be able to increase prices and generate substantial profits.

- Even assuming that prices increase by no more than the annual payments, the major cigarette firms may profit substantially from the proposed settlement through limitations on liability and reductions in advertising and litigation costs. Thus, the industry may be able to achieve significant civil liability limitations for as little as $15 billion ($10 billion in present value, i.e., in current dollars) in reduced domestic operating profits net of income tax. If coordination is enhanced, then they may gain both the liability limits and a significant increase in profits.

- The report provides several possible but uncertain illustrations of the potential effect of the settlement on prices, profits, and public sector revenues, if coordination is enhanced and the firms raise price by more than necessary to simply "pass through" to consumers the amount of the annual payments. Under one scenario, for example, the additional operating profits net of income tax due to enhanced industry coordination could amount to $36 billion over the next 25 years ($16 billion present value). Under another scenario, reflecting substantially more effective coordination than at present, possible additional operating profits net of income tax may be $123 billion over the next 25 years ($56 billion present value).

- Higher prices from more effective coordination would result in larger revenues for the public sector as well as increased operating profits to the cigarette manufacturers.

The public sector would benefit through greater excess profit penalties under the terms of the settlement and greater revenues from federal corporate income taxes. In general, the examples suggest that the companies would keep about two-thirds of the financial benefits of more effective industry coordination, leaving one-third for the public sector.

- The public sector would gain financially from the settlement proposal, although the annual payments made by the cigarette companies will most likely be considerably less than the $368.5 billion "face value" of the proposed settlement. After taking into account the anticipated decrease in the volume of cigarettes sold (resulting from the likely increase in cigarette prices and a general decline in smoking in the U.S.), the public sector could realize revenues from taxes and the settlement payments of about $207 billion ($100 billion present value), assuming the settlement does not make coordination more effective.

- It is difficult to predict with confidence the price of cigarettes or profits to the cigarette manufacturers over 25 years because the nature of competition may be significantly affected by the proposed settlement. This report concludes that prices and profits could increase substantially, over and above what prices and profits would be in absence of any agreement -- particularly because of the present unduly broad scope of the antitrust exemption.

The report has three sections and an Appendix. The first section describes the history and structure of the industry. The second describes certain provisions of the tobacco settlement, highlighting those (such as the antitrust exemption) that might contribute to a lessening of competition. To provide a tangible view of the potential economic effect of the settlement, the third section provides examples of what might happen to prices, profits, and public sector revenues if the settlement is adopted. Although the examples are illustrations rather than predictions, they help to indicate the kinds of effects and the possible magnitude of the effects that may occur if competition is reduced. The Appendix provides a legal analysis of the proposed antitrust immunity for tobacco product manufacturers.

Industry History and Structure

The cigarette industry has been characterized as an oligopoly in which the firms clearly recognize their mutual interdependence. Although no evidence of explicit collusion has been uncovered, economic histories indicate that the cigarette firms have, for long periods, been able to price cigarettes above competitive levels, notwithstanding infrequent episodes of more intense price competition and product innovation.[1]

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[1] As the Supreme Court observed recently when commenting on the pre-1980s industry: "The (continued...)

Several structural factors support the industry's ability to raise prices above competitive levels. First, there are relatively few firms. Currently, there are only five significant firms and three (Philip Morris, R.J. Reynolds, and Brown & Williamson) account for about 90 percent of the market. Second, overall demand by adults for cigarettes is relatively insensitive to changes in price. Third, the industry is well insulated from entry by new firms. There has been some entry by extremely small firms but none of these firms has garnered a significant competitive presence. Finally, the opportunity for firms tacitly to coordinate price increases is enhanced because changes in price can be quickly matched by rival firms, making price-cutting an unprofitable short-run strategy.

The industry, however, while not an example of perfect competition, is pricing cigarettes today below the price that would be chosen by the industry if the companies were behaving as a perfect cartel. Firms that prefer a relatively low price, for example, may effectively limit the ability of their rivals to increase prices in a coordinated fashion.

The settlement could have an important effect on competition in this market. It has the potential to enhance the ability of these firms to coordinate their actions. In particular, as currently drafted, the antitrust exemption may allow explicit discussions of pricing and may also allow the firms to find means to tacitly collude or to induce reluctant firms to raise prices.

More effective coordination could have significant consequences. Any factors that enhance the firms' ability to coordinate likely would result in much larger price increases than would be associated with a simple pass-through of the settlement payments. While a substantial price increase in cigarettes may be contemplated as one immediate goal of the proposed settlement, the amount of the resulting price increase could be higher than the cost to industry of the settlement payments, resulting in higher industry operating profits.

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cigarette industry . . . has long been one of America's most profitable, in part because for many years there was no significant price competition among the rival firms. . . . List prices for cigarettes increased in lock-step twice a year, for a number of years, irrespective of the rate of inflation, changes in the cost of production, or shifts in consumer demand." Brooke Group, Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209, 213 (1993)(citation omitted).

Analysis of Specific Terms of the Settlement

The report analyzes the effects of various aspects of the settlement on prices and competition. One of the most important aspects of the settlement is an annual payment structure which specifies certain levels of payments, beginning at $8.5 billion in 1998, increasing to $15 billion in 2002, and remaining stable thereafter. The precise amount of the annual payments is linked to the volume of cigarettes sold each year and industry profits.

The report observes that there is reason to believe that cigarette prices will increase by more than is necessary simply to "pass through" the annual payments to consumers. First, many economic studies have demonstrated that the industry has effectively passed through to consumers the full amount of federal and state excise tax increases in the past. Based on this history, the report observes that at least 100 percent of the annual payments will likely be passed through. Second, the settlement has the potential to make future coordination between the firms simpler and this, in turn, would better facilitate the achievement of opportunities for price increases. These two factors suggest that the firms could raise price substantially more than the minimum necessary to pass through the settlement payments to consumers, and thus the overall "price-increase ratio" could be much higher than 100 percent.

Three aspects of the settlement have the potential to enhance the ability of firms to coordinate price levels, and thus to facilitate price increases. First, the settlement contains a broad antitrust exemption. Although this exemption is intended to enable the firms to coordinate activities to reduce youth smoking, it may also permit the industry members to discuss pricing arrangements or other agreements that will have the effect of increasing prices. The exemption, as written, may increase the likelihood that prices will move closer to what a monopolist would charge. An Appendix to the report provides more specific analysis of the exemption.

Second, the settlement imposes important restrictions on advertising and marketing intended to reduce the access and appeal of cigarettes to youth. The settlement imposes these and other restrictions as a means to achieve public health goals. Nevertheless, it should be recognized that advertising and marketing are important competitive tools. Advertising and promotion make it easier for new entrants or maverick firms with new products, lower priced products, or new brands to gain market share from the other firms in the market. As a result, restrictions on marketing could raise barriers to entry and expansion and ultimately lead to higher prices.

Third, the settlement could have a disproportionate effect on the small firms at the fringe of the market as well as potential entrants. For example, the settlement envisions that the non-participating firms will pay almost 50 percent higher annual payments over the life of the settlement than would be required if they had decided to participate in the settlement. These payments would be placed in an escrow account and could be reclaimed, with interest, 35 years later if not paid out in liability payments. Because of the difficulty of predicting the amount of future liability payments and the long delay before any money could be reclaimed, these payments will likely be viewed as non-refundable costs of doing business. As a result, they could substantially raise the marginal costs borne by small firms and potential entrants, and may make it less likely they can effectively compete in the market.

Impact of the Settlement

To gauge the economic impact of the settlement on cigarette prices, quantity sold, retail sales revenues, cigarette manufacturing industry profits, and public sector revenues, the report provides several examples of possible outcomes. The report looks at several variables including (1) the extent to which cost increases have historically been "passed through" to consumers, (2) the level of competition and any change in that level of competition as a result of the settlement, (3) the reduction in advertising expenses and the reduction in litigation expenses, and (4) the consumer responsiveness to price increases. The examples are reported in Section III of the report.

The most critical factor is the ability of the firms to coordinate their actions as a result of the settlement. This factor is captured by the price-increase ratio. In the hypothetical examples analyzed below, industry operating profits decline if the firms are simply able to pass through 100 percent of the implicit tax increase, without achieving higher prices through a lessening of competition among the firms. Under such circumstances the price-increase ratio would be 100 percent. Operating profits increase, however, if coordination is made more effective and if, in consequence, the price-increase ratio is 125 or 200 percent. Assuming a 200 percent price-increase ratio, a possible but uncertain event, operating profit levels are over $123 billion higher ($56 billion in present value) than in the 100 percent price-increase ratio case. A 200 percent price-increase ratio augments public sector revenues by $73 billion ($33 billion in present value) in the example relative to the case in which the ratio is only 100 percent, reflecting the historical rate at which the industry passes through cost increases to consumers without any additional price increase resulting from improved coordination.

The hypothetical examples emphasize that as coordination is enhanced and the price-increase ratio rises, significant incremental profits and revenues are generated for industry and the public sector, respectively. The allocation of those additional monies between industry and the public sector, however, is quite unequal: about 2/3 of the resulting additional profits would be retained by the firms and 1/3 would go to the public sector in corporate taxes.

Finally, it is unlikely that the proposed settlement will generate the $368.5 billion "face value" that has been posited as the public sector's gain from the settlement payments. After taking into account the anticipated decrease in the volume of cigarettes sold resulting from the likely increase in cigarette prices and a general decline in smoking in the U.S., the examples indicate that public sector revenues, including taxes along with the new payments proposed by the settlement, could increase by about $207 billion ($100 billion present value) even if the settlement does not make coordination more effective.